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# In the Supreme Court of the United States

OCTOBER TERM, 1975

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No. 75–153

LAND O'LAKES, INC., ETC., PETITIONER

*v.*

UNITED STATES OF AMERICA

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT*

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## BRIEF FOR THE UNITED STATES IN OPPOSITION

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### OPINIONS BELOW

The memorandum and order of the district court (Pet. App. A–1 to A–20) are reported at 362 F. Supp. 1253. The opinion of the court of appeals (Pet. App. B–1 to B–13) is not yet reported.

### JURISDICTION

The judgment of the court of appeals was entered on April 30, 1975. The petition for a writ of certiorari was filed on July 28, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### QUESTION PRESENTED

Whether the Commissioner of Internal Revenue properly revoked the tax-exempt status under Section 521 of the Internal Revenue Code of 1954 of peti-

tioner, an agricultural cooperative, because of its substantial purchases from, and sales to, nonmember and nonproducer firms.

## STATUTES INVOLVED

Section 521(b)(1) and (b)(4) of the Internal Revenue Code of 1954 is set forth at Pet. 3. Section 521 (a) of the Code (as amended by Section 17(b)(1), Revenue Act of 1962, 76 Stat. 1051) provides:

> *Exemption From Tax.* A farmers' cooperative organization described in subsection (b)(1) shall be exempt from taxation under this subtitle except as otherwise provided in part I of subchapter T (sec. 1381 and following). Notwithstanding part I of subchapter T (sec. 1381 and following), such an organization shall be considered an organization exempt from income taxes for purposes of any law which refers to organizations exempt from income taxes.

## STATEMENT

Petitioner is a large agricultural cooperative. Although it is basically a federated cooperative (a cooperative whose members are other cooperatives), it also has some individual members. Petitioner primarily operates as a marketing cooperative, selling butter, milk powder, cheese, fluid milk, ice cream, eggs, poultry and turkeys, both at wholesale and retail.[1] In 1963,

[1] Petitioner's retail marketing activity was conducted primarily through its Bridgeman Division, which in turn operated 20 retail stores or restaurants (R. 74–76, 93). In addition to selling petitioner's members' and other nonmember producers' dairy products, the restaurants sold in 1963 about $977,000 in nonproducer goods, referred to as "sideline" items (R. 93; June 19, 1973, Tr. 3). While the amount of sales of

petitioner's gross marketing sales were approximately $200,000,000. Petitioner also performs a purchasing or supply function for its member patrons, buying and processing approximately $30,000,000 worth of seed, feed, fertilizer and equipment each year and selling them to its members and other patrons (Pet. App. A–2 to A–3; Pet App. B–2; R. 66–70, 76, 93).[2]

On the marketing side, the bulk of petitioner's sales in 1963 were made at wholesale. Petitioner marketed its products through 23 wholesale branches. These branches sold not only the products of petitioner's members and nonmember farmer producers, but also certain other items (such as special cheeses and brown eggs), which petitioner bought from independent proprietary companies (enterprises other than farmer cooperatives). In 1963, petitioner's buying of such nonproducer products for wholesale marketing were approximately $5,600,000 (Pet App. B–4; R. 74–76, 93, 111).

Petitioner bought nonproducer products for sale at wholesale through its wholly-owned subsidiary, Northwest Dairy Products Company, Inc. ("Northwest"). Northwest bought these items from various proprietary companies and transferred them to petitioner at cost. Pursuant to an agreement, petitioner paid Northwest patronage dividends with respect to

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sideline items at retail constituted one of five separate grounds of the Commissioner for revocation of petitioner's exempt status, this ground is not at issue here because it was not considered by the court of appeals.

[2] "R." references are to the record appendix in the court of appeals.

its sales to petitioner.[3] In the following taxable year, Northwest would return the so-called "patronage dividends" to petitioner as a reduction in the price of goods sold. Petitioner then reflected the returned "patronage dividends" in its "patronage dividends" distributed to its members and other producer patrons for that year (R. 69–74, 81). Northwest had no employees. Its directors and officers were employees of petitioner, and its books and records were all maintained by petitioner (Pet. App. B–11; R. 157–158, 255).

On its purchasing or supply side, petitioner's distribution of supplies and equipment to members and other persons was accomplished through member cooperatives, company stores, independent dealers, and through the use of so-called "agent-buyers." The agent-buyers were used in areas where petitioner did not have a member cooperative or company store. The agent-buyer was ordinarily a local feed dealer who in turn resold the products purchased from petitioner. Unlike other independent dealers, the agent-buyers executed agreements with petitioner whereby they agreed to furnish to petitioner sales slips of each sale which they made to producers.

In 1963, petitioner sold almost $2,400,000 in feed and merchandise to agent-buyer dealers for resale to producers (R. 99). Petitioner then paid the producer-customers of the agent-buyer dealers approximately $150,000 in patronage dividends with respect to such transactions (R. 313). All sales to the agent-buyer

[3] These patronage dividends amounted to $63,734.76 in 1963 (Pet App. B–11).

dealers were absolute and final. The agent-buyer dealers established their own retail selling price and markup, and bore all risks of loss. Petitioner periodically furnished the agent-buyers with suggested price lists, but they were under no obligation to follow them (R. 76–79, 212–220).

For many years, petitioner had been exempt from income taxes as provided by Section 521 of the Internal Revenue Code of 1954 and its statutory predecessors (R. 4). In 1970, the Commissioner of Internal Revenue concluded that since 1963, various aspects of petitioner's dealings with nonmember-nonproducers had not complied with several requirements for "exempt" status under Section 521. Accordingly, the Commissioner determined that petitioner was no longer entitled to 'exempt' status for its taxable years beginning January 1, 1963 (Pet. App. A–2). Prior to the Commissioner's determination, petitioner had already decided in 1970 not to attempt to retain "exempt" status for its taxable years after 1970 (Pet. 10).

Petitioner brought this refund suit in the United States District Court for the District of Minnesota to challenge the withdrawal of its Section 521 status as it affected its tax liability for the year 1963. The district court upheld petitioner and rejected the government's five alternative grounds for revocation of petitioner's exempt status[4] (Pet. App. A–1 to A–20).

[4] These grounds were: (1) that petitioner's $2,400,000 in sales of supplies to agent-buyers constituted sales to nonmember-nonproducers, thereby exceeding the 15-percent limit in Section 521(b)(4); (2) that such sales additionally contra-

The court of appeals reversed and remanded the case to the district court. It held that the Commissioner correctly revoked petitioner's exempt status under Section 521 because: (1) petitioner's distribution and sale to agent-buyer dealers of supplies and equipment that it had purchased were made to nonproducers, so that petitioner's purchases of supplies for nonproducers exceeded the 15-percent limitation of Section 521(b)(4); (2) petitioner's sales through agent-buyer dealers were not at "actual cost, plus necessary expenses" as required by Section 521(b)(1); and (3) petitioner's marketing of approximately $5,600,000 in nonproducer goods bought from proprietary companies through Northwest, and its payment of the approximately $64,000 in patronage dividends to the nonproducer Northwest, was contrary to Section 521(b)(1), which requires that an exempt cooperative market only the products of members or other producers. Because a non-exempt cooperative is eligible for deductions for certain patronage dividends under Section 1382(b), the court of appeals remanded the case to the district court for it to determine the

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vened Section 521(b)(1) because they were not made "at actual cost, plus necessary expenses"; (3) that petitioner's distribution of almost $64,000 in patronage dividends to its subsidiary, Northwest, a nonproducer, was contrary to the requirement of Section 521(b)(1) that a cooperative market only the products of members or producers; (4) that petitioner's marketing of more than $5,000,000 in nonproducer products at wholesale was contrary to the requirement of Section 521(b)(1) that such marketing activities be conducted only for members; and (5) that petitioner's marketing of almost $1,000,000 of nonproducer products at retail similarly contravened Section 521(b)(1) (See Pet. App. B–5, n. 4).

amount of the patronage dividend deductions to which petitioner was entitled (Pet. App. B–1 to B–13).

## ARGUMENT

The court of appeals correctly upheld the Commissioner's revocation of petitioner's exempt status. Petitioner acknowledges (Pet. 16) that the decision is the "the first judicial construction of the statute for all practical purposes" and that the statute has never before been construed (Pet. 8) "in an authoritative way by lower courts." Moreover, the decision has limited significance for petitioner, since it has not claimed the benefits of the statute in question for its taxable years after 1970. There is accordingly no reason for review by this Court.

1. Section 521(a) of the 1954 Code provides that certain farmers' cooperatives shall be "exempt" from income taxes, if they meet the detailed requirements of Section 521(b). These requirements are designed principally to restrict the extent to which the farmers' cooperative may transact business with nonmember farmers and nonfarmers (*i.e.*, nonproducers). If a cooperative meets the requirements for Section 521(a) exempt status, it is permitted a variety of deductions which usually enables it to reduce its taxable income to zero. For example, an exempt cooperative is allowed a deduction for amounts paid to patrons with respect to business done with the cooperative (*viz.*, patronage dividends), amounts paid to patrons from investment sources, and for dividends on capital stock. See Sections 1381–1383, 1385, 1388. However, a non-exempt cooperative is only

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entitled to a deduction for certain patronage dividend payments. See Section 1382(b).

Congress intended to limit the "exempt" cooperatives receiving the additional deductions to those that comply with the restrictions in Section 521(b), which are designed to limit the cooperative's business and activities to farmer producers. See *Co-operative Grain & Supply Co.* v. *Commissioner*, 407 F. 2d 1158, 1162 (C.A. 8); *Farmers Union Co-op Co.* v. *Commissioner*, 90 F. 2d 488, 493 (C.A. 8). As the court of appeals correctly recognized (Pet. App. B-8 to B-9):

> Persuasive policy reasons support this [strict] construction [of Section 521]. Congress provided tax-exempt status for agricultural cooperatives satisfying certain carefully defined criteria in order to enable the farmer-members of such cooperatives better to compete in the marketplace. Congress made the determination that agricultural cooperatives which could not comply with these criteria did not need the competitive advantages conferred by tax exemption. *See generally* Paul, *Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes*, 29 Minn. L. Rev. 343 (1945).

2. The court of appeals correctly held that petitioner's agent-buyer plan did not satisfy the 15-percent limitation of Section 521(b)(4) on a cooperative's sales of merchandise and supplies to nonmember-nonproducers. That provision states that the value of purchases of supplies made by a cooperative for

nonmember-nonproducers may not exceed 15-percent of the value of all of its purchases.

Prior to 1963, petitioner sold most of its supplies and equipment to member cooperatives, or through its own company stores to farmer-customers. At that time, petitioner sold only a small portion of such supplies and equipment to independent dealers for resale to farmers and other customers. However, as sales through cooperative channels declined and sales through independent dealers increased, petitioner's sales to nonmember-nonproducers began to reach the 15-percent limit in Section 521(b)(4).

Petitioner thereupon formulated the device of the agent-buyer system. Under this system, independent dealers purportedly agreed that they would be agents of prospective customers for petitioner's supplies and equipment, and agreed that they would allow payment of the patronage dividends attributable to these sales to such customers (Pet. App. B–6 to B–7).

It is evident that the single purpose of this plan was to ensure that for purposes of the 15-percent limitation in Section 521(b)(4), the farmer-customers of the agent-buyers would be classified as customers of petitioner, so as to prevent petitioner's nonproducer sales from exceeding the 15-percent statutory limit. But the agent-buyer dealers were not in fact agents of their producer-customers and petitioner does not argue to the contrary. Thus, petitioner's sales to the agent-buyer dealers were nothing other than sales to the dealers themselves, who were nonmember-non-

producers.[5] As the court of appeals stated, "taxpayer elected to wholesale its supplies to nonmember proprietary stores which resold these items at retail" (Pet. App. B–10). Thus, petitioner's total wholesale sales to nonmember-nonproducers exceeded the 15-percent statutory limitation.

Petitioner's emphasis (Pet. 12–13) on the economic and other reasons which prompted it to engage in such substantial wholesaling through agent-buyer dealers, and the fact that the agent-buyer dealers made only small profits, are irrelevant. Section 521(b)(4) makes no exceptions for sales to nonmember-nonproducers simply because such sales may have produced a small profit or been prompted by changing economic conditions.[6]

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[5] The court of appeals summarized its conclusion that the agent-buyer dealers were not agents of producers, but were nonmember-nonproducer purchasers from petitioner as follows (Pet. App. B–7 to B–8):

"Notwithstanding the taxpayer's intent to create a cooperative-patron arrangement with the farmer-consumer, the record establishes that Land O'Lakes sold its supplies unconditionally to the retail outlets without knowing the identity of the persons who would receive the products as alleged "principals." The risk of loss or sale remained with the retailers on delivery. The agent-buyer remained free to sell the retail price on his sale to a customer and would gain the profit or bear any loss incident to the sale. Except for their obligation to forward sales slips to the taxpayer, agent-buyers, who operated farm stores and sold primarily to farmers, market Land O'Lakes' products just as they did any other inventory item."

[6] Although petitioner contends (Pet. 12) that its sales through agent-buyers were "relatively small," they were almost $2,400,000 in 1963 (R. 99).

The court of appeals also correctly held that even if the sales to the agent-buyers were considered to be made to the farmer-customers, petitioner did not qualify for tax-exempt status because it did not make such sales "at actual cost, plus necessary expenses" as required by Section 521(b)(1) of the Code (see Pet. App. B–10). The agent-buyers did not distribute supplies and equipment to their farmer-customers at a fixed service fee, but rather charged any price the market would bear. This middleman profit cannot be squared with the fundamental cooperative principle, reflected in Section 521(b)(1), that cooperatives turn over supplies to their member patrons at cost plus necessary expenses. Since the agent-buyer dealers' profits were not rebated to their farmer-customers, petitioner did not comply with the "cost, plus necessary expenses" requirement in Section 521(b)(1).

3. Moreover, the court of appeals correctly upheld the Commissioner's revocation of petitioner's exempt status on the alternative ground that petitioner had not complied with Section 521(b)(1) (Pet. App. B–10 to B–13). That section provides that an exempt cooperative, on its marketing side, may market only "the products of *members* or * * * *producers*" and turn back only "to *them* the proceeds of sales, less * * * expenses" (emphasis added). Petitioner violated these provisions by marketing $5,597,320 of products obtained from nonproducers in 1963 (R. 92), and paying $63,735 in patronage dividends to its wholly-owned subsidiary, Northwest, which was indisputably a nonproducer (Pet. 15; App. B–11).

Northwest bought nonproducer food products from proprietary companies for use in petitioner's retail restaurants, and for marketing to petitioner's wholesale customers. It then resold these products to petitioner. The next year Northwest was paid the $63,735 in patronage dividends by petitioner as in the case of any other member. In the following year, Northwest credited the amount of the previous year's dividends to petitioner by reducing the cost of goods sold to petitioner; and in the next year (two years after the original sales to petitioner) the resulting profits were distributed as patronage dividends by petitioner to all of its producer patrons.

Petitioner contends (Pet. 13, 15) that this wholesale marketing of nonproducer items complied with Section 521(b)(1) because it aided the marketing of the farmers' products and resulted in diverting patronage dividends back to them. But the sale of almost $5,600,000 in nonproducer goods cannot be justified on the basis of a purpose to help farmers, when the statute explicitly prohibits such nonproducer sales by exempt cooperatives.[7] The fact that the attendant

[7] In certain carefully and narrowly confined circumstances, the Internal Revenue Service has administratively sanctioned the limited marketing of nonproducer products by exempt cooperatives. For example, in Rev. Proc. 67-37, 1967-2 Cum. Bull. 668, exempt cooperatives were allowed to market *at retail* a minimal amount of certain types of nonproducer items. In Rev. Rul. 69-222, 1969-1 Cum. Bull. 161, exempt cooperatives were allowed to sell products purchased from nonproducers in certain emergency situations. The court of appeals recognized the validity of such limited exceptions (Pet. App. B-12). Contrary to petitioner's contention (Pet. 14), these administrative excep-

patronage dividends ultimately may have been returned to farmers does not meet the requirement of Section 521(b)(1) that such dividends be directly returned to producers.

4. Implicitly recognizing the weakness of its contentions that it complied with the literal requirements of Section 521, petitioner argues (Pet. 10–15) that the statute should be interpreted liberally to countenance its practices. While a departure from the literal terms of a statute may, on limited occasions, be necessary to effectuate the legislative purpose (see, *e.g.*, *Board of Governors* v. *Agnew*, 329 U.S. 441, 446–448), the legislative purpose of the predecessor provisions of Section 521 affords no basis for such a departure here. As the various authorities construing the requirements of Section 521(b) make clear, Congress intended to ensure that exempt cooperatives have strictly limited dealings with nonmembers and nonproducers. See, *e.g.*, *Dr. P. Phillips Cooperative* v. *Commissioner*, 17 T.C. 1002; *Northwestern Drug Co.* v. *Commissioner*, 14 B.T.A. 222; I.T. 3853, 1947–1 Cum. Bull. 42; also see Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 Tex. L. Rev. 250, 274 (1965). A strict interpretation of Section 521(b) is necessary to accomplish that purpose.[8]

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tions do not sanction its wholesale marketing of $5,600,000 in nonproducer goods, or its payment of patronage dividends to the nonproducer Northwest.

[8] Petitioner's reliance (Pet. 10–11) upon legislative history (S. Rep. No. 52, 69th Cong., 1st Sess. 23–24 (1926); 1939–1 Cum. Bull. (Part 2) 332, 349–350) as further support for a liberal interpretation of Section 521 is misplaced. That history basically

5. Finally, petitioner claims (Pet. 14–15) that the decision in this case will have an adverse effect on the 5,000 farmer cooperatives. Petitioner however, has not shown how many of these cooperatives engage in the practices held by the court of appeals to violate Section 521(b). Without such a showing, there is no basis to petitioner's assertions of the importance of the question presented.

## CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1975.

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reflects a congressional recognition, and statutory approval (see Section 231(12) of the Revenue Act of 1926 44 Stat. 40), of the Treasury Department's prior administrative practice of permitting exempt farmers' cooperative to market the products of nonmember producers. But while Congress im the Revenue Act of 1926 did sanction certain dealings by exempt cooperatives with nonmember-producers, it also continued the prohibitions and limitations on exempt cooperatives' dealings with nonmember-nonproducers. It is this latter aspect of the statute upon which the revocation of petitioner's tax-exempt status rests.

U.S. GOVERNMENT PRINTING OFFICE: 1976